Discussion of New Accounting Rules that Affect Non-Profits

September 27, 2017

Agenda

- Introduction
- Proposed changes, Timeframe, process
- Topics for Discussion:
  - Net asset classifications
  - Credit losses/Allowance for Loan Losses
  - Functional Expenses/investment expenses
  - Consolidation Disclosure (Liquidity)
  - Other Accounting Changes
- Wrap-up and Evaluation

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Panel

- Beth Lipson, OFN, Moderator
- Accounting Advisor Panel
  - Colleen Williams, RSM US LLP
  - Anne Schrantz, CohnReznick LLP
  - Jyothi Narayan, Vavrinek, Trine, Day & Co. LLP
  - David Conway, Novogradac & Company LLP

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Introduction

- Performance Counts
  - Goals & Accomplishments
  - Topics covered:
    - Net Assets, Liquidity/Cash Management, Portfolio Performance, New Accounting Rules, Covenants
- Proposed Accounting Rules
  - 2015 - Industry response to FASB (letter)
  - 2016 - Attendance at FASB Forum
  - 2017 - Information Sharing with industry

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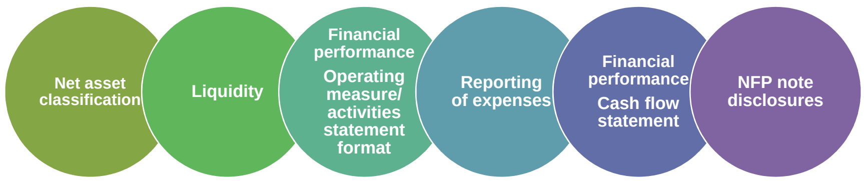
ASU 2016-14 – Topics Considered by Nonprofit Advisory Committee



NOTE: Board removed NFP Other Financial Communications (MD&A) project from its research agenda in January 2014.

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ASU 2016-14 – Effective Date and Transition

- **<u>Effective date</u>**: For fiscal years beginning after 12/15/2017 (e.g., CY 2018 or FY)
  - Interim financials the following year
- **<u>Early Adoption</u>**: Permitted, but must apply the regular transition provisions.
- **<u>Transition:</u>**
  - For year of adoption: apply <u>all</u> provisions.
  - For comparative years presented: apply all provisions, except can choose not be present:
    - a) Analysis of expenses by nature and function, and/or
    - b) Disclosures around liquidity and availability of resources

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ASU 2016-14 – Early Adoption

- Advantages:
  - Simplify presentation in statement of activities and statement of financial position
  - Presentation of restrictions from donors more closely matches legal restrictions, in particular as it relates to underwater endowments, and the requirement to treat endowments as a single pool
  - Enables use of simplified statement of cash flows.
  - Financial statements will become easier to understand by users – boards, donors, funders, government.
- Disadvantages:
  - For entities that do not currently present expenses by natural classification it will expand required disclosure
  - Additional required liquidity disclosure
  - Other disclosure modifications required

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ASU 2016-14 – Implement half way?

- NFPs can incorporate many of the ideas from the ASU
- The following cannot be changed without formal adoption:
  1) Combining temporarily and permanently restricted net assets
  2) Accounting for underwater endowments in restricted net assets
  3) Eliminating disclosure of investment expenses and return components
  4) Eliminated current requirements for the cash flow reconciliation if the direct method is used

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ASU 2016-14 - Net asset classification

Current GAAP	Revised GAAP
Net Assets:	**Net Assets:**
• Unrestricted • Temporarily Restricted • Permanently Restricted	• Without Donor Restrictions • With Donor Restrictions
	Disclosure:
	• Amount, purpose and type of board designations • Nature and amount of donor restrictions
"Underwater" Endowments	**Net Assets:**
• Reduce unrestricted net assets	• Reflect in net assets with donor restrictions
	Disclosure:
	• Aggregate of original gift amounts, fair value • Board policy

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ASU 2016-14 - Net asset classification

Current GAAP	Revised GAAP
Net Assets:	**Net Assets:**

• Gifts of cash restricted for acquisition or construction of long-lived assets:
  • Implied time restriction, or
  • Placed-in-service approach
	• All NFPs will be required to use placed-in service approach
	• Time restriction only if explicit by donor

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Credit Losses / Allowance for Loan Losses (CECL)

- Removes the “probable” threshold and the “incurred” notion as triggers for credit loss recognition.
- Instead, all financial instruments carried at amortized cost (for NFPs this is generally loans receivable) should reflect the net amount expected to be collected, i.e. lifetime credit losses.
- Broadens the range of data that should be considered to measure credit losses.

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Credit Losses / Allowance for Loan Losses (CECL)

- Data should include forward-looking information, such as reasonable and supportable forecasts in assessing collectability of financial assets.
- Conceptually, an allowance will be created upon the origination or acquisition of a financial asset measured at amortized cost.
- Under CECL, the total amount of net charge-offs doesn’t change – rather the timing of credit loss provision changes

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Credit Losses/Allowance for Loan Losses (CECL)

- For CDFIs, this guidance does not become effective until calendar year 2021
- Upon initial adoption, the earlier recognition of credit losses under CECL will likely increase allowance levels and lower net assets
- Credit quality disclosures are expected to expand, however, vintage disclosures required for public financial institutions will be optional for not-for-profit entities

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REPORTING OF INVESTMENT RETURN

How to present?

- **Net presentation** of investment expenses against investment return on the face of the statement of activities
  - Netting limited to external and **direct** internal expenses
  - May report net return in **multiple**, appropriately labeled lines (e.g., from different portfolios, in different net asset classes, or in operating versus non-operating)

What to disclose?

- Disclosure of investment expenses **no longer required**
  - If reported, carefully label and don't include in expense analysis
- No longer require disclosure of investment return **components**

* Source: FASB Presentation, *IN FOCUS:* Accounting Standards Update on Not-for-Profit Financial Statements (ASU 2016-14) - Sept. 2016

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REPORTING OF INVESTMENT RETURN

- Direct internal investment expenses involve the direct conduct or direct supervision of the strategic and tactical activities involved in generating investment return. These include, but are not limited to, both of the following:
  - Salaries, benefits, travel, and other costs associated with the officer and staff responsible for the development and execution of investment strategy
  - Allocable costs associated with internal investment management and supervising, selecting, and monitoring of external investment management firms. (**958-225-45-14A)**
- The current standard allows the option to net investment expense against revenue (both internal and external); however, organizations are required to disclose the netted expense.

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EXPENSE REPORTING

- Under the new standard, ALL NFP's will be required to present expenses by function AND nature. **(958-720-45-15).**
- This information must be shown in one location (either all in the notes or all on the face of the financial statements.
- Under current GAAP, all NFP's must present expenses by function and currently **only** voluntary health and welfare organizations are required to also present expenses by their nature (rent , salaries , etc.)

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EXPENSE REPORTING (CONT'D.) DISCLOSURES

- NFPs will also be required to provide qualitative disclosures about the methods used to allocate costs among program and support functions **(958-720-50-1)**
- Will be required to assess which activities are direct conduct or direct supervision of a program or support function and, therefore, would require allocation of costs.
- Will be required to disclose the cost allocation method used to allocate costs of activities identifiable with one or more program, fundraising, or membership-development activities. Some examples CEO, CFO, Human Resources Dept. and Grant Accounting and Reporting (**958-720-55-171-175)**

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SAMPLE STATEMENT OF FUNCTIONAL EXPENSES

ABC ORGANIZATION

Statement of Functional Expenses
Year Ended XXXX

	Program services			Supporting services			
	Program A	Program B	Total Progam	Management and general	Fund-raising	Total Support Services	Total Expenses
Salaries and wages							
Payroll taxes and employee benefits							
Total salaries and related expenses							
Professional fees							
Travel							
Books, dues and subscriptions							
Advertising							
Occupancy							
Repairs and maintenance							
Stationery, supplies and printing							
Postage and shipping							
Telephone							
Insurance							
Interest							
Depreciation and amortization							
Other							
Total expenses							

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EXAMPLE FOOTNOTE: QUALITATIVE DISCLOSURE ABOUT EXPENSE ALLOCATIONS

- **Note X. Methods Used for Allocation of Expenses from Management and**
- **General Activities**
- The financial statements report certain categories of expenses that are attributable to one or more program or supporting functions of the Organization. Those expenses include depreciation and amortization, the president's office, communications department, and information technology department. Depreciation is allocated based on square footage, the president's office is allocated based on estimates of time and effort, certain costs of the communications department are allocated based on estimates of time and effort, and the information technology department is allocated based on estimates of time and costs of specific technology utilized.

- Reproduced from FASB ASU 2016-14 (958-720-55-176)

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NOT-FOR-PROFIT ENTITIES – CONSOLIDATION – ASU 2017-02

- **Clarifying When a Not-for-Profit Entity Should Consolidate a For-Profit Limited Partnership or Similar Entity**
- Clarifies that NFPs are not subject to VIE consideration and as such the presumption that a NFP general partner controls a for-profit limited partnership or similar legal entity, regardless of the extent of its ownership interest
- Presumption of control is overcome if the limited partners have either:
  - Substantive kick-out rights or
  - Substantive participating rights

- The ASU also modifies certain definitions utilized in that determination.

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NOT-FOR-PROFIT ENTITIES – CONSOLIDATION – ASU 2017-02

- Key Definitions
- **Kick out rights** - The rights of the limited partner to dissolve the limited partnership or otherwise remove the general partner **without cause**.
- **Participating rights** - The rights that allow the limited partners to block or participate in certain significant financial and operating decisions of the limited partnership that are made in the **ordinary course of business**. Examples include but not limited to:
  - Selecting, terminating and setting the compensation for management responsible for the limited partnership's policies and procedures
  - Establishing operating and capital decisions of the limited partnership include budgets, in the ordinary course of business.
- **Protective rights** - The rights that are only protective in nature and that do not allow the limited partners to participate in financial and operating decisions of the limited partnership that are made in the **ordinary course of business**.

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Liquidity Requirements

NFPs will be required to provide information useful in assessing liquidity including:

- Qualitative information in the notes that communicates how an NFP manages its liquid resources available to meet cash needs for general expenditures within one year of the balance sheet date
- Quantitative information either on the face of the balance sheet or in the notes, and additional qualitative information in the notes as necessary, that communicates the availability of an NFP's financial assets at the balance sheet date to meet cash needs for general expenditures within one year of the balance sheet date.

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Liquidity – Financial Assets

- Cash and cash equivalents
- Short-term investments
- Receivables
- Pledges
- Inventory

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Liquidity – Restrictions

- Donor restrictions for capital expenditures or other expenses beyond the next year
- Funds designated by the board
- Assets held as collateral
- Loan covenants
- Cash required to be held in separate accounts or restricted for a specific purpose

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Liquidity – Preparation

- Identify financial assets
- Determine limits imposed on financial assets
- Calculate amounts available to meet cash needs within 1 year
- Consider classified statement of financial position
- Change GL setup to better track financial assets

Liquidity - Example Disclosure

The following reflects Not-for-Profit Entity A's financial assets as of the balance sheet date, reduced by amounts not available for general use because of contractual or donor-imposed restrictions within one year of the balance sheet date. Amounts not available include amounts set aside for long-term investing in the quasi-endowment that could be drawn upon if the governing board approves that action. However, amounts already appropriated from either the donor-restricted endowment or quasi-endowment for general expenditure within one year of the balance sheet date have not been subtracted as unavailable.

Liquidity - Example Disclosure

Financial assets, at year-end	$ 234,410
Unavailable for general expenditures within one year, due to:	
Contractual or donor-imposed restrictions:	
Restricted by donor with time or purpose restrictions	(11,940)
Subject to appropriation and satisfaction of donor restrictions	(174,700)
Investments held in annuity trust	(4,500)
Board designations:	
Quasi-endowment fund, primarily for long-term investing	(36,600)
Amounts set aside for liquidity reserve	(1,300)
Financial assets available to meet cash needs for general expenditures within one year	$ 5,370

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Liquidity – Qualitative Disclosures

Qualitative disclosures on managing liquidity should communicate:

- Strategy for addressing liquidity risks
- Policy for establishing liquidity reserves

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Liquidity - Example Disclosure

Not-for-Profit Entity A is substantially supported by restricted contributions. Because a donor's restriction requires resources to be used in a particular manner or in a future period, Not-for-Profit Entity A must maintain sufficient resources to meet those responsibilities to its donors. Thus, financial assets may not be available for general expenditure within one year. As part of Not for-Profit Entity A's liquidity management, it has a policy to structure its financial assets to be available as its general expenditures, liabilities, and other obligations come due. In addition, Not-for-Profit Entity A invests cash in excess of daily requirements in short-term investments.

Occasionally, the board designates a portion of any operating surplus to its liquidity reserve, which was $1,300 as of June 30, 20X1. There is a fund established by the governing board that may be drawn upon in the event of financial distress or an immediate liquidity need resulting from events outside the typical life cycle of converting financial assets to cash or settling financial liabilities. In the event of an unanticipated liquidity need, Not-for-Profit Entity A also could draw upon $10,000 of available lines of credit (as further discussed in Note XX) or its quasi-endowment fund.

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Accounting for Contributions

- FASB exposure draft – August 2017
- Exchange versus contribution
  - Did contributor receive value in return?
- Distinguishing between conditional and unconditional contributions
  - Is there a barrier that must be overcome?
  - Is there a right of return?
- Comments due by November 1, 2017

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Wrap Up

- Additional Questions
- What Additional Information & Resources are helpful for the industry
- What other topics would be helpful to cover related financial statements, accounting, and financial management?

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